Exchange-Traded Funds (ETFs)

Exchange-traded funds, or ETFs, are investment companies that are legally classified as open-end companies or Unit Investment Trusts (UITs), but that differ from traditional open-end companies and UITs in the following respects:

- ETFs do not sell individual shares directly to investors and only issue their shares in large blocks (blocks of 50,000 shares, for example) that are known as "Creation Units."
- Investors generally do not purchase Creation Units with cash. Instead, they buy Creation Units with a basket of securities that generally mirrors the ETF's portfolio. Those who purchase Creation Units are frequently institutions.
- After purchasing a Creation Unit, an investor often splits it up and sells the individual shares on a secondary market. This permits other investors to purchase individual shares (instead of Creation Units).

Investors who want to sell their ETF shares have two options: (1) they can sell individual shares to other investors on the secondary market, or (2) they can sell the Creation Units back to the ETF. In addition, ETFs generally redeem Creation Units by giving investors the securities that comprise the portfolio instead of cash. So, for example, an ETF invested in the stocks contained in the Dow Jones Industrial Average (DJIA) would give a redeeming shareholder the actual securities that constitute the DJIA instead of cash. Because of the limited redeemability of ETF shares, ETFs are not considered to be—and may not call themselves—mutual funds.

An ETF, like any other type of investment company, will have a prospectus. All investors that purchase Creation Units receive a prospectus. Some ETFs may furnish an investor with a summary prospectus containing key information about the ETF instead of a long-form prospectus. If an investor receives a summary prospectus, the ETF's long-form prospectus will be available on an Internet Web site, and an investor can obtain a paper copy upon request and without charge. Some broker-dealers also deliver a prospectus to secondary market purchasers. ETFs that do not deliver a prospectus are required to give investors a document known as a Product Description, which summarizes key information about the ETF and explains how to obtain a prospectus. All ETFs will deliver a prospectus upon request. Before purchasing ETF shares, you should carefully read all of an ETF's available information, including its prospectus.

The websites of the New York Stock Exchange and NASDAQ provide more information about different types of ETFs and how they work. An ETF will have annual operating expenses and may also impose certain shareholders fees that are disclosed in the prospectus.

Most ETFs seek to achieve the same return as a particular market index. That type of ETF is similar to an index fund in that it will primarily invest in the securities of companies that are included in a selected market index. An ETF will invest in either all of the securities or a representative sample of the securities included in the index. For example, one type of ETF, known as Spiders or SPDRs, invests in all of the stocks contained in the S&P 500 Composite Stock Price Index. Other types of ETFs include leveraged or inverse ETFs, which are ETFs that seek to achieve a daily return that is a multiple or an inverse multiple of the daily return of a securities index. An important characteristic of these ETFs is that they seek to achieve their stated objectives on a daily basis, and their performance over longer periods of time can differ significantly from the multiple or inverse multiple of the index performance over those longer periods of time. ETFs also include actively managed ETFs that pursue active management strategies and publish their portfolio holdings on a daily basis.

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